

Washington State Investment Board Economically Targeted Investment Policy 2003 Annual Report

Introduction and Summary

The Washington State Investment Board (WSIB or Board) manages about \$53 billion in assets for 33 separate state retirement and public funds. The Board conducts its investment activities in accordance with investment policies and procedures designed to maximize return at a prudent level of risk. Asset allocation is the driver of investment performance. Accordingly, the WSIB invests in basic asset classes including Public Equity (U.S. Equity and Non-U.S. Equity), Fixed Income, Real Estate, and Private Equity to help control risk and ensure stronger performance overall.

This is the first progress report of the WSIB Economically Targeted Investments (ETIs) policy approved in March 2003. In the initial annual poll of WSIB's private equity General Partners (GPs) deal flow activity for fiscal year 2003, the key findings included the following:

- 36 GPs looked at 567 Washington-based opportunities
- 30 deals were still in the pipeline at fiscal year end
- 29 deals were completed
- There is no problem attracting venture capital firms to come to the region to look at deals
- Not all deals get done

Washington is rich with investment opportunity and has earned the interest and access to top quality GPs. The WSIB's GPs actively seek quality opportunities based in Washington and deals are getting done in Washington.

The WSIB believes the state of Washington is an excellent place in which to invest a portion of the trust funds under management by the Board. Over \$1.3 billion in value is currently held in the WSIB investment portfolio in Washington-based investments through its public equity, fixed income, real estate and private equity investment programs. These investments were made consistent with the WSIB's statutory mandate. More than \$5.2 billion in private equity commitments have yet to be called, representing significant capital ready to put to work as qualified investment opportunities arise.

The WSIB has made a strong commitment to facilitate access to and awareness of quality in-state investment opportunities. Further, it has devoted resources to implement that policy and to track future in-state investment activity. The WSIB will work with the Washington Technology Center (WTC) to assist Washington companies achieve exposure to potential sources of capital and provide feedback regarding educational and investor networking events.

Overview of Policy

In March 2003, the Board adopted a policy with respect to ETIs to communicate the role and responsibilities of the WSIB relative to such initiatives. ETIs are defined in this instance as investments having the primary objective of investment return to pension trust fund assets and the collateral objective of assisting the regional economy, and the economic well-being of the state of Washington, its localities and its residents.

In the ETI policy, the Board reiterated its “fiduciary duty to invest and to manage the entrusted funds in a manner consistent with statutes, regulations, Board policies and the highest standard of professional conduct for the exclusive benefit of fund beneficiaries.” The WSIB established the standard of care for all investments, including investment policies and procedures designed exclusively to maximize return at a prudent level of risk. Those mandates apply to the evaluation of all investment opportunities, including ETIs. The Board will continue to seek quality investment opportunities within the state in accordance with its established policies, statutory mandates and fiduciary duty.

The policy holds the Board responsible for requesting its private equity GPs to report annually on Washington-based investments evaluated during the prior year. The Board established a staff function to facilitate the exchange of information between its private equity GPs and appropriate parties with knowledge of quality in-state investment opportunities, and in accordance with the policy, to prepare the annual report of its ETI activities to provide to the Board, beneficiaries, the Legislature and the Governor. This report presents the progress to-date of the WSIB policy on ETIs.

Investment Environment

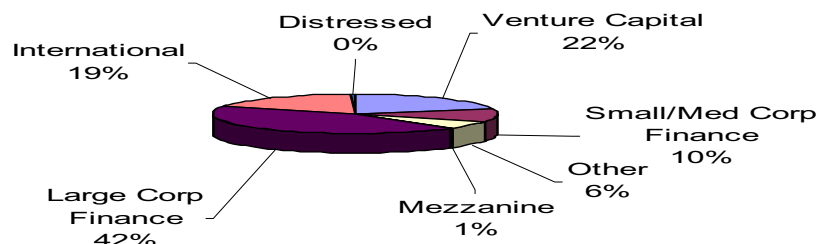
According to Venture Economics, two straight years of quarter-to-quarter declines in venture capital investing ended in the second quarter of 2003 as investments increased slightly. The increase marked the first up tick in the post-bubble era that began in 2001; the increase has continued into the third quarter of 2003. For the fiscal year 2003 (7/1/02-6/30/03), total venture capital investments in the U.S. totaled \$17.3 billion in 2,758 deals. Of that total, \$602 million was invested in 116 deals in the Northwest region (defined as Washington, Oregon, Idaho, Montana and Wyoming). Washington captured 88 of the Northwest deals and \$408.8 million of the new invested dollars. Based on the Venture Economics data, venture deals are getting done in Washington.

Although the portfolio contains other segments of the private market than just venture capital, much of the new investment activity of interest is focused on the venture capital arena. In addition to that focus, the venture segment traditionally has provided more detailed and summary data over longer periods of time and for more investment characteristics than other segments of the private equity industry, allowing more meaningful analysis and comparisons. Buyout activity has also accelerated in the second half of 2002 and early 2003. Much of the buyout activity is reported to stem from corporate divestitures which provided public companies with much-needed cash.

Overhang: An important issue in private equity is whether the industry has too much “overhang.” Overhang represents the amount of available or uninvested capital that has been raised by private equity funds. The overhang in venture capital at the end of 2002 was estimated by Venture Economics in the range of \$45 to \$100 billion. Buyout funds may hold as much as another \$100 billion overhang. It has been suggested that excess capital may encourage unwarranted competition for new deals and lead to overvalued deals. Overhang may further result in over-investment in sectors that cannot support adequate rates of return, raising concerns about how GPs will be able to effectively put the money to work and how future returns may be impacted as a result.

It may be more meaningful for perspective to view the overhang or supply of capital as a ratio to the investment pace or demand for capital, rather than as a stand-alone amount. The ratio is typically presented in years and expresses the amount of capital reserved for future investment. Reserves are a natural part of venture investing since funds typically earmark 25 to 35 percent of a fund for follow-on investing. Over the past 20 years, this reserve ratio has averaged 2.3 years. The ratio for 2001-2002 of 2.4 years actually appears to be in line with historic norms, and less a cause for alarm. Data for the first three quarters of 2003 suggest that the ratio will remain within historic norms for the 2002-2004 investment periods.

A review of the \$5.2 billion WSIB overhang at 6/30/03 by strategy indicates that over half the unfunded commitments are in the areas of corporate finance and that 22 percent is in the venture capital arena.



ETI Reported Activity in 2003

The WSIB continues to assess regional firms in the market and is currently invested in three regional firms: Frazier Healthcare Ventures, OVP Venture Partners and Endeavour Capital (a new relationship).

In October 2003, a letter was sent to 67 of WSIB’s private equity GPs requesting information about their deal flow review in Washington for the year 9/1/02 through 8/31/03, including the number of deals done, number passed and any still in process.

(The poll was not sent to funds which had completed their investment period or funds which do only non-U.S. investing.) A satisfying 76 percent of the funds (51) responded.

The highlights of the report were:

- 36 GPs reported looking at 567 Washington-based opportunities
- 9 GPs completed 29 deals
- 6 other GPs were still considering 30 deals remaining in the pipeline
- 508 deals were reviewed but passed on

These responses suggest that Washington has earned the interest and access of top-quality GPs. Washington is rich with investment opportunity and does not appear to have a problem attracting venture capital firms to come to the region to look at deals and check out companies. It also reveals that not all deals get done.

Investments in Washington

While the WSIB seeks the best investment opportunities regardless of where they are located worldwide, the state of Washington is home to many tremendous companies that offer the WSIB excellent investment opportunities. Many Washington investments are part of each asset class in the WSIB's investment portfolios. The following table reflects a summary of Washington investments in the WSIB portfolio at fiscal years ending June 30, 2002 and 2003.

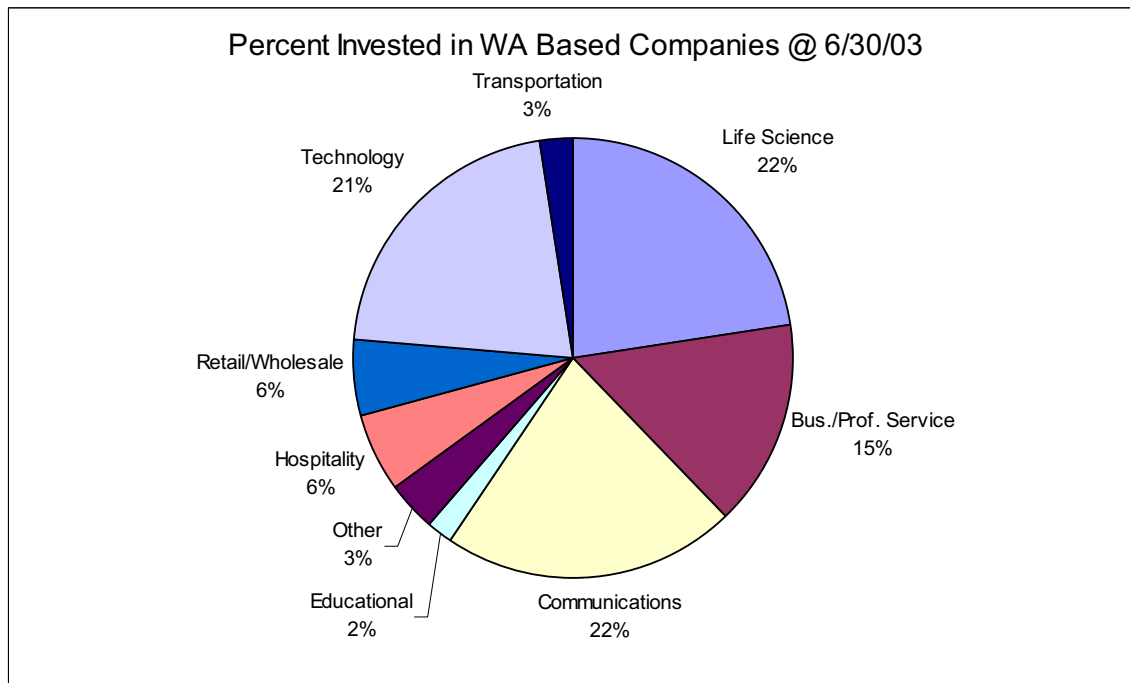
Washington Investments in the WSIB Portfolio (\$ millions)		
Investment Class	Value Fiscal Year ending 6/30/02	Value Fiscal Year ending 6/30/03
Public Equity	\$491.4	\$594.2
Fixed Income	\$465.4	\$317.8
Real Estate	\$667.3	\$343.0
Private Equity	\$61.4	\$59.4
TOTAL	\$1,685.5	\$1,314.4

The WSIB portfolio contains public equity and fixed income investments in 81 Washington companies. In the year-over-year comparison, the value of public equities increased over 20 percent due to the improvements in public market conditions and additional purchases. A near 32 percent decline in fixed income value was predominantly due to bond sales, most to reduce positions in out-of-favor industries and some the result of unfavorable spreads.

The real estate portfolio as of June 30, 2003 includes whole or partial ownership of over 25 office, retail or individual properties located in Washington. Most of the large decline in value for real estate investment in Washington was due to placing a \$200 million mortgage on our largest real estate investment in Washington during this time of historically-low mortgage rates. Additionally, the total value for 2002 estimated the full fair market value of the Washington properties held by real estate partnerships in which the WSIB participated at that time. In contrast, the real estate total for 2003 represents only the WSIB equity in the properties, to more accurately and consistently present in-state investment details.

The small decline in value year-over-year for private equity was due in part to several exits which returned value to the WSIB and to the continued decline in the fair market value for many private companies in the past fiscal year. As of June 30, 2003, the WSIB had over \$59.4 million invested in 44 Washington companies in its private equity portfolio, representing approximately 1 percent of the total private equity portfolio value. The Washington-based investments are held in 32 different funds by 25 individual general partners (GPs), two of which are Washington-based.

The following chart depicts the breakout of Washington-based investments in private equity by industry, showing that 80 percent are concentrated in life science, technology, communications and business/professional services industries. Four other industries have smaller representation.



The WSIB currently has \$10.8 billion committed to private equity among 87 GPs in over 170 partnership funds. More than \$5.6 billion is already invested in private equity investments. However, nearly half of that committed total, \$5.2 billion, has yet to be

called by the GPs. The unfunded commitment represents a significant amount of capital overhang to be invested in the future by current WSIB GPs, many of whom actively review and evaluate investments in Washington State.

WSIB Policy Implementation

Following the adoption of the ETI policy in March 2003, a private equity investment officer, Janet Kruzel, was hired on August 1, 2003 to focus on in-state activities. Many GPs were contacted to obtain their feedback and advice on how the WSIB can more effectively exchange information with them on quality investment opportunities in Washington and improve access to funding for Washington-based companies.

Ms. Kruzel has initiated multiple efforts to provide exposure and understanding of the Board's policy in the state, and to establish contact with the local and regional organizations and networks to accomplish implementation of the ETI policy. Initial efforts include:

- Meeting with 23 funds, organizations and networks in the region
- Completing a Memorandum of Understanding with the Washington Technology Center (WTC) to foster deal flow
- Serving on the WTC Angel Network Advisory Board
- Participating on the steering committee for WSA 2004 Investment Forum
- Attending the Technology Institute, covering the Bio21 initiative
- Attending Frazier's BioTech Leadership meeting of CEOs
- Attending Alliance of Angels monthly meetings
- Continuing ongoing discussions with the WSIB's GPs on ETI policy implementation
- Refining the data collected and collection process
- Developing a baseline of GP activity in Washington
- Monitoring the ETI policies in a number of other states

Looking Forward

During the year 2004, initial implementation efforts will continue to develop and expand. The flexibility of the current policy will allow staff to respond to needs as they arise. Meetings will continue in order to reach more networks and interested parties in the state; and staff interaction with GPs will escalate to encourage continued access and interest in Washington deal flow. The WSIB will work with the WTC to foster deal flow through its Memorandum of Understanding:

- Assist Washington companies to achieve exposure to potential sources of capital through the WSIB's relationship with its GPs
- Establish methods and mechanisms that may help Washington companies become better positioned to seek investment capital

- Improve the WSIB GPs awareness of and accessibility to potential Washington opportunities
- Encourage the WSIB GPs to act as speakers or presenters in WTC educational and investors networking events across the state
- Help the WTC develop guidelines that can be used to groom companies seeking investment capital
- Provide feedback from GPs regarding the initiatives and efforts in which the WTC is involved

Staff will use the baseline that has been established to develop year-over-year performance measures of the policy and continue to refine the methods of data collection.